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BEFORE THE ARIZONA UTILITIES CORPORATION COMMISSION
DOCKETED

CARL J. KUNASEK
CHAIRMAN

JIM IRVIN

COMMISSIONER

WILLIAM A. MUNDELL
COMMISSIONER

NOV 30 1999

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IN THE MATTER OF THE APPLICATION OF
TUCSON ELECTRIC POWER COMPANY FOR
APPROVAL OF ITS PLAN FOR STRANDED
COST RECOVERY.

DOCKET NO. E-01933A-98-0471

IN THE MATTER OF THE FILING OF TUCSON
ELECTRIC POWER COMPANY OF
UNBUNDLED TARIFFS PURSUANT TO A.A.C.
R14-2-1601 *ET SEQ.*

DOCKET NO. E-01933A-97-0772

IN THE MATTER OF COMPETITION IN THE
PROVISION OF ELECTRIC SERVICES
THROUGHOUT THE STATE OF ARIZONA.

DOCKET NO. RE-00000C-94-0165

DECISION NO. 62103OPINION AND ORDER

DATES OF HEARING:

August 9, 1999 (pre-hearing conference), August 11, 12,
and 13, 1999

PLACE OF HEARING:

Tucson, Arizona

PRESIDING OFFICER:

Jerry L. Rudibaugh

IN ATTENDANCE:

William A. Mundell, Commissioner

APPEARANCES:

Mr. Bradley S. Carroll on behalf of Tucson Electric
Power Company;

Mr. Jay L. Shapiro, FENNEMORE CRAIG, on behalf
of Cyprus Climax Metals Co., ASARCO, Inc., and the
Arizonans for Electric Choice & Competition;

Mr. Scott S. Wakefield, Chief Counsel, on behalf of the
Residential Utility Consumer Office;

Mr. Robert S. Lynch, on behalf of M-S-R and Southern
California Public Power Authority;

Mr. Kenneth C. Sundlof, JENNINGS, STROUSS &
SALMON, on behalf of New West Energy;

Mr. Douglas C. Nelson, DOUGLAS C. NELSON, P.C.,
on behalf of Commonwealth Energy Corporation;

Mr. Peter Q. Nyce, Jr., on behalf of the Department of

Defense;

Ms. Loretta Humphrey on behalf of the City of Tucson;

Mr. Lawrence V. Robertson, Jr., MUNGER CHADWICK, on behalf of PG&E Energy Service Corporation, Enron Corp., and Enron Energy Services;

Mr. Albert Sterman on behalf of the Arizona Consumers Council;

Mr. Jeffrey B. Guldner, SNELL & WILMER, on behalf of Arizona Public Service Company; and

Mr. Christopher C. Kempley, Assistant Chief Counsel Legal Division, on behalf of the Utilities Division of the Arizona Corporation Commission.

BY THE COMMISSION:

On December 26, 1996, the Arizona Corporation Commission ("Commission") in Decision No. 59943 enacted A.A.C. R14-2-1601 through R14-2-1616 ("Rules" or "Electric Competition Rules").

On June 22, 1998, the Commission issued Decision No. 60977, the Stranded Cost Order which required each Affected Utility to file a plan for stranded cost recovery.

On August 10, 1998, the Commission issued Decision No. 61071 which made modifications to the Rules on an emergency basis.

On August 21, 1998, Tucson Electric Power Company ("TEP") filed its Stranded Costs plan.

On November 5, 1998, TEP filed a Settlement Proposal that had been entered into with the Commission's Utilities Division Staff ("Staff Settlement Proposal"). Our November 24, 1998 Procedural Order set the matter for hearing. On November 25, 1998, the Commission issued Decision No. 61259 which established an expedited procedural schedule for evidentiary hearings on the Staff Settlement Proposal.

On November 30, 1998, the Arizona Attorney General's Office, in association with numerous other parties, filed a Verified Petition for Special Action and Writ of Mandamus with the Arizona Supreme Court ("Court") regarding the Commission's November 25, 1998 Procedural Order, Decision No. 61259. The Attorney General sought a Stay of the Commission's consideration of the Staff Settlement Proposal with TEP and Arizona Public Service Company ("APS").

1 On December 1, 1998, Vice Chief Justice Charles J. Jones granted a Motion for Immediate
2 Stay of the Procedural Order. On December 9, 1998, the Commission Staff filed a notice with the
3 Supreme Court that the Staff Settlement Proposal had been withdrawn from Commission
4 consideration.

5 On April 27, 1999, the Commission issued Decision No. 61677, which modified Decision No.
6 60977. On June 9, 1999, TEP filed with the Commission a Notice of Filing, Application for
7 Approval of Settlement Agreement ("Settlement" or "Agreement")¹ and Request for Expedited
8 Procedural Order.

9 Our June 23, 1999 Procedural Order set the matter for hearing commencing on August 11,
10 1999.

11 This matter came before a duly authorized Hearing Officer of the Commission at its offices in
12 Tucson, Arizona. TEP, Cyprus Climax Metals, Co., ASARCO, Inc., Arizonans for Electric Choice &
13 Competition ("AECC"), Residential Utility Consumer Office ("RUCO"), the Arizona Community
14 Action Association ("ACAA"), the Arizona Consumers Council, M-S-R and Southern California
15 Public Power Authority, the Arizona Utility Investors Association, Enron Corporation, PG&E Energy
16 Services, the Department of the Defense, Arizona Public Service Company, Commonwealth Energy
17 Corporation ("Commonwealth"), the City of Tucson, New West Energy, and Staff of the
18 Commission appeared through counsel. Evidence was presented concerning the Settlement
19 Agreement, and after a full public hearing, this matter was adjourned pending submission of a
20 Recommended Opinion and Order by the Presiding Officer to the Commission. In addition, a post-
21 hearing briefing schedule was established with simultaneous briefs filed on August 30, 1999.

22 DISCUSSION

23 Introduction

24
25 The Parties to the Proposed Settlement are as follows: the Residential Utility Consumer Office, Tucson Electric
26 Power Company, Arizona Community Action Association and the Arizonans for Electric Choice and Competition which
27 is a coalition of companies and associations in support of competition that includes Cable Systems International, BHP
28 Copper, Motorola, Chemical Lime, Intel, Honeywell, Allied Signal, Cyprus Climax Metals, Asarco, Phelps Dodge,
Homebuilders of Central Arizona, Arizona Mining Industry Gets Our Support, Arizona Food Marketing Alliance,
Arizona Association of Industries, Arizona Multi-housing Association, Arizona Rock Products Association, Arizona
Restaurant Association, Arizona Retailers Association, Boeing, Arizona School Board Association, National Federation
of Independent Business, Arizona Hospital Association, Lockheed Martin, Abbot Labs and Raytheon.

1 The Settlement provides for rate reductions for residential and business customers; sets the
 2 amount, method, and recovery period of stranded costs that TEP can collect in customer charges;
 3 establishes unbundled rates; and provides that TEP will separate its generating facilities, which will
 4 operate in the competitive market, from its distribution system, which will continue to be regulated.

5 According to TEP, the Settlement was the product of months of hard negotiations with
 6 various customer groups. TEP opined that the Settlement provides many clear benefits to customers,
 7 potential competitors, as well as to TEP. Some of those benefits as listed by TEP are as follows:

- 8 • Allowing competition to commence in TEP's service territory months before
 9 otherwise possible and expanding the initial eligible load by 54 MW;
- 10 • Establishing both Standard Offer and Direct Access rates, and providing for a rate
 11 reduction of one percent on July 1, 1999 and another one percent on July 1, 2000;
- 12 • Ensuring stability and certainty for both bundled and unbundled rates;
- 13 • Resolving the issue of TEP's stranded costs and regulatory asset recovery in a fair and
 14 equitable manner;
- 15 • Providing for the divestiture of generation and competitive services by TEP in a cost-
 16 effective manner;
- 17 • Removing the specter of years of litigation and appeals involving TEP and the
 18 Commission over competition-related issues;
- 19 • Continuing support for a regional Independent System Operator ("ISO") and the
 20 Arizona Independent Scheduling Administrator ("AISA");
- 21 • Continuing support for low income programs, DSM and renewable programs; and
- 22 • An interim code of conduct to address affiliate relationships is set forth.

23 The Settlement was entered into by RUCO and the ACAA reflecting the Agreement by TEP's
 24 residential customers to the Settlement's terms and conditions. In addition, the Settlement was
 25 executed by the AECC, a coalition of commercial and industrial customers and trade associations.
 26 AECC opined that since residential and non-residential customers have agreed to the Settlement, the
 27 "public interest" has been served. AECC indicated the Settlement was not perfect but was the result
 28 of "give and take" by each of the parties. Accordingly, AECC urged the Commission to protect the

1 "public interest" by approving the Settlement and not allow Energy Service Providers ("ESPs") to
2 delay the benefits that competition has to offer.

3 Legal Issues

4 In TEP's last general rate case (Decision No. 59594, dated March 29, 1996), the Commission
5 determined a fair value rate base ("FVRB") and a fair value rate of return ("FVROR") that
6 established the bundled rates and charges for TEP. According to TEP, its proposed unbundled
7 distribution rates are simply the unbundling of TEP's approved bundled rates as required by the
8 Commission's Electric Competition Rules. As a result, TEP opined that no new finding of FVRB is
9 necessary in this non-rate case. TEP also argued that there are not constitutional provisions, statutes
10 or regulations that require a rate case filing before the Commission can approve a voluntary rate
11 reduction. TEP indicated the Commission has previously approved Settlement agreements that
12 contained rate decreases/rate moratoriums for public service corporations (See Decision No. 59594,
13 dated March 29, 1996 and Decision No. 61104, dated August 29, 1998).

14 The Commission made a fair value determination in Decision No. 59594 and found TEP's
15 rates were just and reasonable. TEP's rates were reduced by settlement in Decision No. 61104.
16 Pursuant to the Agreement, TEP's existing rates will be unbundled. Accordingly, we find that no
17 additional financial analysis is legally necessary to justify unbundling of TEP's current rate levels.

18 Fixed and Floating Competitive Transition Charges

19 TEP estimated it has stranded costs of approximately \$683 million through 2008. Pursuant to
20 the Agreement, TEP would be authorized to collect the stranded cost through a competition transition
21 charge ("CTC") in two components: (i) a "Fixed" CTC; and (ii) a "Floating" CTC. The Fixed CTC
22 would be set at 0.93 cents/kWh which allows TEP to recover regulatory assets in the amount of \$200
23 million and above market generation costs of \$250 million or a total of four hundred and fifty million
24 dollars (\$450 million). The Fixed CTC will terminate after \$450 million has been collected or on
25 December 31, 2008, whichever occurs first. Upon termination, unbundled rates will be reduced by
26 the 0.93 cents/kWh amount.

27 TEP opined that any market assumptions through 2008 are almost certainly to be wrong. It is
28 for that reason that TEP proposed the floating component of the CTC to ensure that TEP neither over

1 or under-recovers stranded costs. As a result, the remaining \$233 million (\$683 million less fixed
2 amount of \$450 million) of estimated stranded cost are to be collected through the Floating CTC.
3 The Floating CTC will be calculated using a Market Generation Credit ("MGC") methodology. The
4 Floating CTC changes inversely with market prices. It will be a combination of both an on-peak and
5 off-peak value which will be determined on a quarterly basis and will utilize a formula that
6 incorporates various information including the Palo Verde NYMEX future prices. According to
7 AECC, the Floating CTC provides a hedge against fluctuations in the market price.

8 Commonwealth opined that the Floating CTC will provide no incentive for TEP to be
9 efficient. DOD also opposed the use of a Floating CTC for several reasons. First, it is unclear as to
10 the amount or the nature of these costs. Second, the Company testified that the Floating CTC would
11 include both fixed and variable costs. DOD opined that it is unlikely that any variable costs
12 associated with the operation of the Springerville generating facility could be classified as stranded
13 costs. As a result, DOD recommended a schedule of fixed CTCs, by class of customer. According to
14 DOD, a fixed approach is easier understood by both energy service providers as well as TEP's
15 customers. In addition, it provides assurances that CTCs will decline in future years. Further, a fixed
16 CTC will reduce the complexity of accounting for stranded cost collections.

17 Staff and PG&E supported the use of a Fixed and Floating CTC. In addition, Staff confirmed
18 that the total estimated stranded cost was at the low end of the range of potential stranded costs that
19 TEP will actually experience. Further, AECC opined that the total stranded cost resulting from this
20 Settlement was several hundred million dollars less than the Staff Settlement proposal.

21 The DOD proposal is similar to the APS Settlement. However, in APS there was much less
22 of a risk of over collection of stranded costs because APS agreed to write-off approximately \$183
23 million and the estimations only went out to 2004 instead of 2008. The risk of over-collection in this
24 case is much greater because there are little, if any, write-offs and the market estimations go out over
25 an additional four years. As a result, we find the combination of a Fixed and Floating CTC to be
26 reasonable and appropriate under the circumstances herein.

27 Shopping Credit/Adder

28 Similar to the APS Settlement, one of the contentious issues in the hearing was the level of

1 the "shopping credit". The "shopping credit" is the difference between the customer's Standard Offer
2 Rate and the Direct Access Rate available to customers who take service from ESPs. TEP's proposed
3 shopping credit included both a market generation credit as well as an Adder (to reflect additional
4 retail costs). As a result, most of the contentiousness at the hearing revolved around the sufficiency
5 of the Adder in determining the level of the shopping credit.

6 For ease of customer understanding, Staff recommended that the bills for TEP's customers
7 reflect the market generation credit and Adder as a combined shopping credit for generation. In
8 addition, Staff as well as the ESPs asserted that the Adder was not high enough to convert the
9 wholesale price to a retail price. According to Staff, the proposed Adder did not pick up costs such as
10 power procurement, load balancing costs, scheduling, and administrative and general costs.

11 Initially, TEP and the other signatories to the Agreement opposed any change to the
12 Adder/Shopping Credit. During the hearing, TEP and the other signatories subsequently agreed to
13 increase the Adder to the level recommended by Staff.² As a result, both Staff and New West Energy
14 supported the revised Adder. PG&E also praised the parties for revising the Adder upward.
15 However, PG&E indicated it was unable to conclude if such revisions were sufficient enough to
16 allow for meaningful and sustained competition into TEP's service area.

17 Based on the evidence presented, the Adder/Shopping Credit as revised by the parties to
18 incorporate Staff's recommendations appears to be reasonable to allow ESPs to compete in an
19 efficient manner. Further, the market generation credit and Adder should be combined on customer
20 bills as recommended by Staff.

21 Allocation of Stranded Cost

22 According to DOD, the Average and Peaks ("A & 4CP") method used by TEP to unbundle its
23 rates was first adopted by the Commission in Decision No. 58497, dated January 13, 1994 and
24 subsequently confirmed in the subsequent rate settlement, Decision No. 59594, dated March 29,
25 1996. DOD indicated it utilized the A & 4CP method to allocate TEP's total estimated stranded costs
26 of \$683 million over DOD's proposed schedule of fixed CTCs for each customer class. As a result,
27

28 ² The revised Adder will increase stranded costs by approximately \$10 million.

1 DOD calculated an amount of \$119 million to be assigned to contract customers. While TEP agreed
2 that there should be some recovery of stranded costs from contract customers, they did not know how
3 much was currently being recovered from those customers. DOD opined that special contract
4 customers are not paying their fair share of stranded costs. DOD urged the Commission to require
5 that non-contract customers not subsidize the stranded costs that should be allocated to contract
6 customers.

7 According to DOD, the Commission in Docket Nos. U-1933-93-066 and U-1933-95-117 held
8 that the stockholders of TEP and not its non-contract customers should absorb any stranded costs
9 properly allocable to contract customers. In Decision No. 59594, the Commission included the
10 following Conclusion of Law No. 6:

11 "Based on the Agreement as modified herein it is appropriate for
12 TEP to be granted increased overall revenues in the amount of 1.1 percent,
13 to be spread across the board. If no increase is given to special contracts,
14 the total revenue increase will be less than 1.1 percent. If given to all
customers, the revenue increase will be \$6.4 million."

15 DOD also recommended the Commission issue an accounting order that sets TEP's total
16 stranded costs, allocates those costs to customer classes and prescribes the manner in which the
17 recovery of those costs are to be calculated and recorded on TEP's books. Further, DOD requested
18 TEP be ordered to report on a quarterly basis the amount of stranded costs it has collected from direct
19 access customers and bundled rate customers. According to DOD, this will reduce weeks of debate
20 during the proposed 2004 rate case as to the amount of stranded costs that have been allocated.

21 In response, both AECC and TEP asserted that the DOD proposal is not consistent with
22 A.A.C. R14-2-1607(G) which provides that:

23 "Stranded Cost shall be recovered from customer classes in a manner consistent
24 with the specific company's current rate treatment of the stranded asset, in order
25 to effect a recovery of Stranded Cost that is in substantially the same proportion
as the recovery of similar costs from customers or customer classes under current
rates."

26 In addition, AECC and TEP opined that the DOD proposal was also not consistent with the
27 requirement in the Commission's Cost Order that states that:

28 "No customer or customer class shall receive a rate increase as a result of stranded

1 cost recovery by an Affected Utility.”

2 We do share some of the concerns of the DOD. Clearly, the non-contract customers should
3 not be paying the stranded costs of contract customers. According to the parties, the method of the
4 Settlement is designed to insure such protection. Consequently, there have been contracts entered
5 into by TEP subsequent to its last rate case that have resulted in those contract customers paying less
6 stranded costs, then TEP's shareholders should have to absorb those reductions. Similarly, if TEP
7 did not increase the charges to contract customers by the 1.1 percent pursuant to Decision No. 59549,
8 then TEP should absorb those costs. Those amounts, if any, and if not already absorbed by TEP,
9 should be reduced from the stranded costs paid by the non-contract customers. We shall also order
10 TEP to file within 30 days of the date of this Decision an informational report for Staff that
11 demonstrates how much stranded costs will be collected from each customer class. As part of this
12 report, TEP needs to demonstrate that any reductions to contract customers since the last rate case
13 (Decision No. 59594) did not affect the amount of stranded costs collected from those customers or
14 that TEP has absorbed any such reduction. We also shall require TEP to file a quarterly report with
15 the Director of the Utilities Division setting forth the amount of stranded costs collected for each
16 quarter as well as the cumulative amount, and it should be separated into amounts collected from the
17 Fixed and the Floating CTC for both direct access and bundled rate customers.

18 Metering and Billing Credits

19 Staff recommended the metering and billing charges be set at the level the Company filed in
20 the November Settlement. According to Staff, those rates reflect cost levels and methodology from
21 TEP's last general rate case. Staff opined the rates in the Settlement were adjusted downward by the
22 Company to satisfy the constraint of the bundled rates. TEP responded that the downward adjustment
23 was necessary to satisfy the constraint that unbundled components sum to bundled rates. TEP
24 asserted that all of its rates and charges were unbundled in the same manner. If the Staff method is
25 used, TEP argued that it would violate the basis premise that unbundled charges should sum to the
26 bundled components. According to TEP, the Commission and other interested parties can re-examine
27 this issue at the 2004 filing.

28 We concur with Staff. The proposed credits for metering, meter reading and billing will result

1 in a direct access customer paying a portion of TEP's costs as well as a portion of the ESP's costs.
2 We believe this would stymie the competitive market for these services. As a result, we find the
3 approval of the Settlement should be conditioned upon the use of Staff's proposed credits for
4 metering, meter reading and billing.

5 MSR and SCPPA Contracts with TEP

6 MSR and SCPPA did not oppose the Agreement as long as it was made clear that existing
7 contract obligations by TEP would not be affected. As a result, MSR and SCPPA requested the
8 following modifications to TEP's Proposed Form of Order:

- 9 1. Add to Findings of Fact No. 9 the following quote from the revised Settlement
10 Agreement:

11 "(xii) On or before December 31, 2002, TEP shall transfer its generation and other
12 assets deemed to be competitive (as defined in the Electric Competition Rules) to a
13 subsidiary of TEP, at market value."

- 14 2. Add to Findings of Fact No. 18 the following:

15 "The terms and conditions of the Settlement Agreement, when implemented, are not
16 intended to interfere with, prevent or deter the ongoing performance of existing
17 contractual obligations by TEP, including agreements with MSR and SCPPA."

- 18 3. Add to Conclusions of Law No. 7 the following:

19 "The approval of the Settlement Agreement, including the divestiture of TEP's
20 generation and other assets deemed to be competitive (as defined in the Electric
21 Competition Rules) to a subsidiary of TEP, at market value, is not intended to interfere
22 with, prevent or deter the ongoing performance of existing contractual obligations by
23 TEP.

24 MSR and SCPPA indicated that the addition to Findings of Fact No. 9 was a direct quote
25 already contained in the Agreement. According to MSR and SCPPA, the additions to Findings of
26 Fact No. 18 and Conclusions of Law No. 7 was agreed to by TEP at the hearing. Based on the above,
27 MSR and SCPPA requested the proposed additions to Findings of Fact Nos. 9 and 18 and
28 Conclusions of Law No. 7 be included in any order approving the Settlement.

1 Since the proposed Findings of Fact No. 9 is already contained in the Agreement, we do not
2 find it necessary to include the language a second time. Based on the testimony at the hearing,
3 proposed Findings of Fact No. 18 and Conclusions of Law No. 7 reflect the intent of the parties.
4 Accordingly, we shall include these as part of this Decision.

5 Section 2.1(g)

6 Section 2.1(g) of the Settlement would authorize TEP to securitize any portion of the CTC.
7 Staff requested the Commission clarify the nature of the proposed securitization. Section 2.1(g)
8 provides the following:

9 The Commission shall authorize TEP to securitize any portion of
10 the CTC, provided that TEP shall file with the Commission a financing
11 application that provides that TEP will share the benefits of such
securitization with its customers.

12 Staff requested that it be made clear that securitization will require consideration and further
13 order by the Commission. We concur with Staff. TEP will need to demonstrate that any proposed
14 securitization plan is in the public interest prior to the Commission granting approval. As part of that
15 demonstration, we will require TEP to provide all details surrounding any involvement by Prudential
16 Securities regarding the previous Staff Settlement Agreement as well as this Agreement.
17 Accordingly, we shall direct the parties to file an amended Section 2.1(g) as follows:

18 TEP shall file a securitization plan for any portion of the CTC.
19 Such financing application will provide that TEP will share the benefits of
20 such securitization with its customers. The Commission shall issue an
21 order authorizing the securitization if TEP can demonstrate that it is in the
public interest.

22 Section 14.3

23 Staff was concerned with some of the binding language in the Agreement and in particular with the
24 following in Section 14.3:

25 14.3 To the extent any provision of this Agreement is inconsistent with
26 any existing or future Commission order, rule or regulation or is
27 inconsistent with the Electric Competition Rules as now existing or
28 as may be amended in the future, the provisions of this Agreement
shall control and the approval of the Agreement by the
Commission shall be deemed to constitute a Commission-approved
variation or exemption to any conflicting provision of the Electric

Competition Rules.

Staff recommended the Commission not approve Section 14.3

We share Staff's concerns. We also recognize that the parties want to preserve their benefits to their Agreement. We agree with the parties that to the extent any provision of the Agreement is inconsistent with the Electric Competition Rules as finalized by the Commission in September 1999, the provisions of the Agreement shall control. We want to make it clear that the Commission does not intend to revisit the stranded cost portion of the Agreement. It is also not the Commission's intent to undermine the benefits that parties have bargained for. With that said, the Commission must be able to make rule changes/other future modifications that become necessary over time. As a result, we will direct the parties to file a revised Section 14.3 consistent with the revised Section 7.1 of the Arizona Public Service Company Settlement Agreement.

Waivers

As part of the proposed Settlement, the Company requested waivers of various conditions set forth in Decision No. 60480, dated November 25, 1997. According to TEP, the conditions set forth in Decision No. 60480 were designed to address TEP as a vertically integrated utility on a going forward basis indefinitely. TEP subsequently revised many of those requests in order to satisfy concerns raised by Staff. As to Condition Nos. 23 and 25, Staff recommended consideration of a waiver for those conditions be deferred until consideration of TEP's Final Code of Conduct. TEP disagreed and requested a waiver be granted now. TEP indicated that Condition Nos. 23 and 25 require employees of TEP to keep time sheets on a "positive basis" and for TEP, UniSource and sister companies to maintain up-to-date job descriptions. According to TEP, Conditions Nos. 23 and 25 are unnecessary in light of the Code of Conduct and would put TEP at a competitive disadvantage. Further, TEP indicated that Conditions Nos. 23 and 25 were put in place as a result of TEP being a vertically integrated utility in a holding company structure.

We concur with Staff. We will defer consideration of any waiver of Conditions Nos. 23 and 25 until consideration of TEP's Final Code of Conduct.

Interim Code of Conduct

On July 21, 1999, TEP filed an Interim Code of Conduct agreed to by the parties to the

1 Agreement. TEP indicated that it had modeled its Interim Code of Conduct ("Interim Code") after
2 the Affiliate Transactions Rule that was in an earlier version of the Electric Competition Rules. TEP
3 urged its Interim Code be approved until such time a final Code of Conduct is approved by the
4 Commission. PG&E recommended the Commission's Hearing Division establish an expedited
5 procedural schedule to allow all interested parties to be heard in regards to the proposed Interim Code
6 of Conduct.

7 Based on the above, we will direct TEP to file a revised Code of Conduct with the
8 Commission no later than 30 days of the date of this Decision. Such Code of Conduct should also
9 include provisions to govern the supply of generation during the two-year period of delay for the
10 transfer of generation assets so that TEP doesn't give itself an undue advantage over the ESPs. All
11 parties shall have 60 days from the date of this Decision to provide their comments to TEP regarding
12 the revised Code of Conduct. TEP shall file its final Code of Conduct within 90 days of the date of
13 this Decision. Subsequently, within 10 days of filing the final Code of Conduct, the Hearing Division
14 shall establish a procedural schedule to hear the matter.

15 Section 13.4

16 Several of the parties expressed concern that Section 13.4 of the Agreement allows TEP to
17 seek rate increases under specified conditions. Staff recommended the Commission condition
18 approval of the Agreement on Section 13.4 being amended to include language that the Commission
19 or Staff may commence rate change proceedings under conditions paralleling those provided to the
20 utility, including response to petitions submitted under A.R.S. § 40-246.

21 We agree that Section 13.4 is too restrictive on the Commission's future action. Accordingly,
22 we will condition approval of the Agreement on inclusion of the following language in Section 13.4:

23 Neither the Commission nor TEP shall be prevented from seeking or
24 authorizing a change in unbundled or Standard Offer rates prior to
25 December 31, 2008, in the event of (a) conditions or circumstances which
26 constitute an emergency, such as an inability to finance on reasonable
27 terms, or (b) material changes in TEP's cost-of-service for Commission-
28 regulated services resulting from federal, tribal, state or local laws,
regulatory requirements, judicial decisions, actions or orders. Except for
the changes otherwise specifically contemplated by this Agreement,
unbundled and Standard Offer rates shall remain unchanged until at least

December 31, 2008.

Cost-of-Service

Some of the parties urged that a new cost-of-service study be ordered with a hearing to be completed no later than June 30, 2000. TEP's unbundled rates are based on the allocation of costs from its 1994 test year. Further, under the Agreement any review would be postponed until 2004 with new rates not going into effect until January 1, 2005.

We find that it is not necessary to file a revised cost-of-service study at this time. The proposed Standard Offer rates contained in the Settlement are based on existing tariffs approved by this Commission. In addition, a full rate case with a revised cost-of-service study would result in months/years of additional delay. Lastly, the Standard Offer rates as proposed in the Settlement are consistent with the Commission's requirement that no customer shall receive a rate increase. The following was extracted from Decision No. 61677:

"No customer or customers class shall receive a rate increase as a result of stranded cost recovery by an Affected utility under any of these options."

Generation Subsidiary

Section 3.1 of the Agreement provides the following:

3.1 On or before December 31, 2002, TEP shall transfer its generation and other assets deemed to be competitive (as defined in the Electric Competition Rules) to a subsidiary of TEP, at market value. Commission approval of this Settlement Agreement shall constitute any necessary approval or waiver under Title 40, Arizona Revised Statutes and the Commission's Affiliated Interest Rules (A.A.C. R14-2-801, *et seq.*) for the formations of the subsidiary and the transfer of the assets. At such time that TEP effectuates the transfer of its generation assets, it shall be required to procure generation for its standard offer customers in accordance with the Electric Competition Rules.

PG&E³ indicated the provision that provides for the transfer of generation assets at market value is an improvement over the transfer provision contained in the APS Settlement Agreement. Some parties questioned how the market value would be determined.

The Commission supports and authorizes the transfer by TEP to a subsidiary of all its generation and competitive electric service assets as set forth in the Agreement no later than December 31, 2002. However, we will require the Company to provide the Commission with a specific list of any assets to be so transferred, along with their net book values as well as market values at the time of transfer, at least thirty days prior to the actual transfer. The Commission

³ Enron Corp. and Enron Energy Services Corporation adopted the viewpoints set forth in the Post-Hearing Brief filed by PG&E.

1 reserves the right to verify whether such specific assets are for the provision of generation and other
2 competitive electric services or whether there are additional TEP assets that should be so transferred.
3 Further, the Commission reserves the right to review the appropriate market price for the assets.

4 Section 5.2

5 Pursuant to Section 5.2 of the Agreement, TEP shall file a report with the Commission by
6 June 1, 2004 identifying possible modifications to the Fixed or Floating CTC that would affect TEP's
7 rates. Section 5.2 reads as follows:

8 5.2 TEP shall file a report with the Director of the Utilities Division by June 1, 2004
9 identifying any required modifications to the Fixed or Floating CTC, TEP's distribution
10 tariffs and other unbundled components ("TEP June 1, 2004 filing"), that would have the
11 effect of reducing standard offer and/or overall unbundled rates while providing for TEP's
12 recovery of costs associated with provider of last resort service in standard offer rates. This
13 report shall include a recommendation as to whether the Fixed CTC can be
14 eliminated/reduced prior to December 31, 2008. Any changes in TEP's rates made pursuant
15 to this section 5.2 shall be implemented no later than January 1, 2005.

16 Staff recommended the following language be added to Section 5.2: Any increase in rate
17 components will be accompanied by decreases in other rate components.

18 We are concerned that Section 5.2 does not provide for any meaningful review of TEP's rate
19 structure. The APS Settlement required APS to file a general rate case by June 30, 2003 with rate
20 changes sometime near July 1, 2004. Consistent with TEP's stated intent at the hearing, we shall
21 order TEP to file a general rate case with prefiled testimony and supporting schedules and exhibits
22 including an updated cost-of-service study on or before June 1, 2004. Any rate changes resulting
23 therefrom shall not be effective prior to June 1, 2005. While there can be some rate decreases, no
24 customer shall receive an increase in their overall bill as a result of the rate case to be filed in 2004.

25 Section 4.6

26 Pursuant to Section 4.6 of the Agreement, TEP is deferring costs of implementing
27 Competitive Retail Access for later recovery. An example would be costs for the record keeping for
28 computer programs. TEP estimated it has spent \$10 million, to date, on such costs.

29 We generally support the request of TEP to defer those costs related to implementing
30 Competitive Retail Access including the cost of forming the generation subsidiary. We also
31 recognize the Company is making a business decision to transfer the generation assets to a subsidiary
32 instead of an unrelated party. Because of this business decision, we believe there should be a sharing

1 of such costs between ratepayers and shareholders. While a 50-50 sharing would be appropriate, we
2 believe the Company should be permitted to recover 67 percent of such costs consistent with our
3 decision in the APS Settlement.

4 Modifications

5 During the course of the proceeding, Staff and several Intervenors requested modifications to
6 the Settlement. Consequently, the parties agreed to, and already have, modified the Settlement to
7 incorporate such modifications. See Attachment No. 1. These modifications include:

- 8 • An across the board twenty percent increase in the Adder.
- 9 • Combined MGC and Adder on customers' bills.
- 10 • A clarification that any interested party may participate in future rate proceedings
11 regarding TEP's rates or the Adder.
- 12 • Use of the three-day average when computing the MGC.
- 13 • Utilization of an alternative index for the MGC calculation in the event that the Palo
14 Verde NYMEX becomes unusable.
- 15 • Acceptance of all Staff's recommendations regarding TEP's waiver requests with the
16 exception of Condition Nos. 23 and 25.

17 Additionally, TEP agreed that any interested party should be permitted to participate with
18 respect to TEP's Final Code of Conduct and that TEP will file with the Commission revised tariffs
19 following any changes.

20 Consistent with other discussions herein, we approve the above listed modifications.

21 ANALYSIS/SUMMARY

22 Consistent with our determination in Decision No. 60977, the following primary objectives
23 need to be taken into consideration in deciding the overall stranded cost issue:

- 24 A. Provide the Affected Utilities a reasonable opportunity to collect 100 percent of their
25 unmitigated stranded costs;
- 26 B. Provide incentives for the Affected Utilities to maximize their mitigation effort;
- 27 C. Accelerate the collection of stranded costs into as short of a transition period as
28

possible consistent with other objectives;

- D. Minimize the stranded cost impact on customers remaining on the standard offer;
- E. Don't confuse customers as to the bottom line; and
- F. Have full generation competition as soon as possible.

The Commission also recognized in Decision No. 60977 that the aforementioned objectives were in conflict. Part of that conflict is reflected in the following language extracted from Decision No. 60977:

One of the main concerns expressed over and over by various consumer groups was that the small consumers would end up with higher costs during the transition phase and all the benefits would flow to the larger users. At the time of the hearing, there had been minimal participation in California by residential customers in the competitive electric market place. It is not the Commission's intent to have small consumers pay higher short-term costs in order to provide lower costs for the larger consumers. Accordingly, we will place limitations on stranded cost recovery that will minimize the impact on the standard offer.

Decision No. 61677 modified Decision No. 60977 and allowed each Affected Utility to choose from five options.

With the modifications contained herein, we find the overall Settlement satisfies the objectives set forth in Decision Nos. 60977 and 61677. We believe the Settlement will result in an orderly process that will result in small rate reductions⁴ during the transition period to a competitive generation market. The Settlement allows every TEP customer to have the immediate opportunity to benefit from the change in market structure while maintaining reliability and certainty of delivery. Further, the Settlement in conjunction with the Electric Rules will provide every TEP customer with a choice in a reasonable timeframe and in an orderly manner. This Commission supports competition in the generation market because of increased benefits to customers, including lower rates and greater choice. While some of the potential competitors have argued that higher "shopping credits" will result in greater choice, we find that a higher shopping credit would also mean rate increases for TEP customers. We find that the Settlement strikes the proper balance between competing objectives by allowing immediate rate reductions while maintaining a relatively short transition period for

⁴ There have been instances in other states where customers were told they would receive rate decreases which were then offset by a stranded cost add-on.

1 collection of stranded costs, with a full rate case in 2004. At that point in time, unbundled rates can
2 be modified based upon an updated cost study.

3 While the transition period is four years longer than the APS Settlement and the rate
4 reductions are modest in comparison to the APS Settlement, we recognize that TEP's stranded costs
5 are much larger for a company of its size and its financial strength is much weaker than APS. As a
6 result of the overall circumstances, we find the Settlement as modified herein is reasonable and
7 should be approved.

8 * * * * *

9 Having considered the entire record herein and being fully advised in the premises, the
10 Commission finds, concludes, and orders that:

11 **FINDINGS OF FACT**

12 1. TEP is certificated to provide electric service as a public service corporation in the
13 State of Arizona.

14 2. TEP currently provides retail electric service to the City of Tucson and in the
15 surrounding Pima County areas, and to Fort Huachaca in Cochise County pursuant to Certificates.

16 3. Decision No. 59943 enacted A.A.C. R14-2-1601 through R14-2-1616, the Electric
17 Competition Rules.

18 4. Following a hearing on generic issues related to stranded costs, the Commission issued
19 Decision No. 60977, dated June 22, 1998.

20 5. Decision No. 61071 adopted the Emergency Rules on a permanent basis.

21 6. On August 21, 1998, TEP filed its Stranded Costs plan.

22 7. On November 5, 1998, TEP filed the Staff Settlement Proposal.

23 8. Our November 24, 1998 Procedural Order set the matter for hearing.

24 9. Decision No. 61259 established an expedited procedural schedule for evidentiary
25 hearings on the Staff Settlement Proposal.

26 10. The Court issued a Stay of the Commission's consideration of the Staff Settlement
27 Proposal.

28 11. Staff withdrew the Staff Settlement Proposal from Commission consideration.

1 12. On June 9, 1999, TEP filed its Settlement requesting Commission approval.

2 13. Our June 23, 1999 Procedural Order set the Settlement for hearing commencing on
3 August 11, 1999.

4 14. Decision No. 61311 (January 11, 1999) stayed the effectiveness of the Emergency
5 Rules and related Decisions, and ordered the Hearing Division to conduct further proceedings in this
6 Docket.

7 15. In Decision No. 61634 (April 23, 1999), the Commission adopted modifications to
8 A.A.C. R14-2-201 through -207, -210 and 212 and A.A.C. R14-2-1601 through -1617.

9 16. Pursuant to Decision No. 61677, dated April 27, 1999, the Commission modified
10 Decision No. 60977 whereby each Affected Utility could choose one of the following options: (a)
11 Net Revenues Lost Methodology; (b) Divestiture/Auction Methodology; (c) Financial Integrity
12 Methodology; (d) Settlement Methodology; and (e) the Alternative Methodology.

13 17. TEP and other Affected Utilities filed with the Arizona Superior Court various appeals
14 of Commission Orders adopting the Competition Rules and related Stranded Cost Decisions (the
15 "Outstanding Litigation").

16 18. Pursuant to Decision No. 61677, TEP, RUCO, AECC, and ACAA entered into the
17 Settlement to resolve numerous issues, including stranded costs and unbundled tariffs.

18 19. The difference between market based prices and the cost of regulated power has been
19 generally referred to as stranded costs.

20 20. Any stranded cost recovery methodology must balance the interests of the Affected
21 Utilities, ratepayers, and the move toward competition.

22 21. All current and future customers of the Affected Utilities should pay their fair share of
23 stranded costs.

24 22. Pursuant to the terms of the Settlement Agreement, TEP has agreed to the
25 modification of its CC&N in order to implement competitive retail access in its Service Territory.

26 23. TEP estimated it has stranded costs of approximately \$683 million through 2008.

27 24. Pursuant to the Agreement, TEP would be authorized to collect the stranded costs
28 through a Fixed CTC and a Floating CTC.

25. The Fixed CTC would be set at 0.93 cents/kWh which allows TEP to recover regulatory assets in the amount of \$200 million and \$250 million of above market generation costs.

26. The Fixed CTC will terminate after \$450 million has been collected or on December 31, 2008, whichever occurs first.

27. Upon termination of the Fixed CTC, unbundled rates will be decreased by 0.93 cents/kWh.

28. The Floating CTC will allow TEP to collect its stranded costs in excess of \$450 million while ensuring that TEP does not over or under-recover stranded costs.

29. The terms and conditions of the Settlement Agreement, when implemented, are not intended to interfere with, prevent or deter the ongoing performance of existing contractual obligations by TEP, including agreements with MSR and SCPPA.

30. RUCO, ACAA, and AECC collectively, represent residential and non-residential customers.

31. The metering and billing credits set forth in the November Settlement Proposal and as recommended by Staff will provide sufficient credits for competitors to compete.

32. A TEP rate case would take a minimum of one year to complete.

33. ESPs that have been certificated have shown more of an interest in serving larger business customers than residential customers.

34. The Settlement will permit competition in a timely and efficient manner and insure all customers benefit during the transition period.

35. TEP's stranded costs on a relative size to APS are much higher.

36. TEP has significantly less shareholder equity relative to APS.

37. TEP's customer bill should include the market generation credit and Adder as a combined shopping credit for generation.

38. In TEP's last general rate case (Decision No. 59594), the Commission determined a FVRB and FVROR that established the bundled rates and charges for TEP.

39. TEP's rates were reduced by Settlement in Decision No. 61104, dated August 28, 1998.

40. TEP's proposed unbundled rates are simply the unbundling of TEP's approved bundled rates.

41. According to TEP and AECC, all customers will be better off under this Agreement than under the Staff Settlement which would have resulted in a “rush to judgment” sale.

42. The Settlement Agreement provides for competitive retail access in TEP's Service Territory, establishes no rate increases for all TEP customers up through 2008, sets a mechanism for stranded cost recovery, and resolves contentious litigation.

43. The terms and conditions of the Settlement Agreement as modified herein are just and reasonable and in the public interest and should be approved.

CONCLUSIONS OF LAW

1. The Affected Utilities are public service corporations within the meaning of the Arizona Constitution, Article XV, under A.R.S. §§ 40-202, -203, -250, -321, -322, -331, -336, -361, -365, -367, and under the Arizona Revised Statutes, Title 40, generally.

2. The Commission has jurisdiction over the Affected Utilities and of the subject matter contained herein.

3. Notice of the proceeding has been given in the manner prescribed by law.

4. The Settlement Agreement as modified herein is just and reasonable and in the public interest and should be approved.

5. TEP should be authorized to implement its Stranded Cost Recovery Plan as set forth in the Settlement Agreement as modified herein.

6. TEP's Certificate should be modified in order to permit competitive retail access in TEP's Certificate service territory.

7. The approval of the Settlement Agreement, including the divestiture of TEP's generation and other assets deemed to be competitive (as defined in the Electric Competition Rules) to a subsidiary of TEP, at market value, is not intended to interfere with, prevent or deter the ongoing performance of existing contractual obligations by TEP.

8. TEP's unbundled rates are an unbundling of TEP's existing bundled rates that were previously approved by the Commission.

ORDER

IT IS THEREFORE ORDERED that the Settlement Agreement as modified herein is hereby approved and all Commission findings, approvals and authorizations requested therein consistent with such modifications are hereby granted.

IT IS FURTHER ORDERED that Tucson Electric Power shall file a revised Settlement Agreement consistent with the modifications herein within 30 days of the date of this Decision.

IT IS FURTHER ORDERED that Tucson Electric Power Company's Certificate is hereby modified to permit competitive retail access consistent with this Decision and the Competition Rules.

IT IS FURTHER ORDERED that within 90 days of the date of this Decision, Tucson Electric Power Company shall file a proposed final Code of Conduct for Commission approval.

IT IS FURTHER ORDERED that within ten days of the date the proposed final Code of Conduct is filed, the Hearing Division shall issue a Procedural Order setting a procedural schedule for consideration of the Code of Conduct.

IT IS FURTHER ORDERED that within 30 days of the date of this Decision, Tucson Electric Power Company shall file an informational report with Staff that demonstrates how much stranded cost will be collected from each customer class, as discussed herein.

IT IS FURTHER ORDERED that Tucson Electric Power Company shall file a general rate case with prefiled testimony and supporting schedules and exhibits including an updated cost-of-service study on or before June 1, 2004.

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1 IT IS FURTHER ORDERED that Tucson Electric Power Company shall file a quarterly
2 report with the Director of the Utilities Division setting forth the amount of stranded costs collected
3 for each quarter as well as the cumulative amount for both the Fixed and Floating CTC for both direct
4 access and bundled rate customers.

5 IT IS FURTHER ORDERED that this Decision shall become effective immediately.

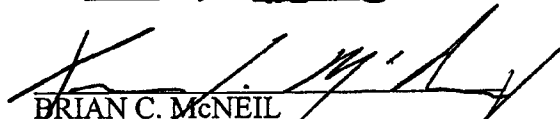
6 BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

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8 
9 CHAIRMAN

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12 COMMISSIONER

13 COMMISSIONER

14 IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive
15 Secretary of the Arizona Corporation Commission, have
16 hereunto set my hand and caused the official seal of the
17 Commission to be affixed at the Capitol, in the City of Phoenix,
18 this 30th day of November 1999.

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21 BRIAN C. McNEIL
22 EXECUTIVE SECRETARY

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1 SERVICE LIST FOR: TUCSON ELECTRIC POWER COMPANY
2 DOCKET NOS.: E-01933A-98-0471, E-01933A-97-0772 and RE-
3 00000C-94-0165

4 Service List for RE-00000C-94-0165

5 Lyn Farmer, Chief Counsel
6 LEGAL DIVISION
1200 W. Washington Street
Phoenix, Arizona 85007

7 Deborah Scott, Director
8 UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION
1200 W. Washington Street
9 Phoenix, Arizona 85007

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ATTACHMENT NO. 1

AMENDED SETTLEMENT AGREEMENT

This Settlement Agreement is entered into this 9th day of June, 1999 by Tucson Electric Power Company ("TEP" or the "Company"), the Arizona Residential Utility Consumer Office ("RUCO"), members of the Arizonans For Electric Choice And Competition ("AECC")¹ and Arizona Community Action Association ("ACAA") (collectively the "Parties").

BACKGROUND

A. TEP is a public service corporation that, along with its predecessors, has provided electric service in Arizona since 1892. TEP currently provides retail electric service to the City of Tucson and in the surrounding Pima County area, and to Fort Huachuca in Cochise County pursuant to Certificates of Convenience and Necessity ("CC&Ns"); these areas shall collectively be referred to as the "TEP CC&N Service Territory") that it has received from the Arizona Corporation Commission ("Commission").

B. On December 26, 1996, the Commission issued an Order approving A.A.C. R14-2-1601, *et seq.* (the "Electric Competition Rules") for the purpose of introducing competitive access to retail electric generation and certain other services that are deemed to be competitive (hereinafter referred to as "Competitive Retail Access"). Since then, the Electric Competition Rules have been the subject of multiple litigation and the

¹ AECC consists of the following organizations: Arizonans for Electric Choice and Competition is a coalition of energy consumers in support of competition and includes Cable Systems International, BHP Copper, Motorola, Chemical Lime, Intel, Honeywell, Allied Signal, Cyprus Climax Metals, Asarco, Phelps Dodge, Homebuilders of Central Arizona, Arizona Mining Industry Gets Our Support, Arizona Food Marketing Alliance, Arizona Association of Industries, Arizona Multihousing Association, Arizona Rock Products Association, Arizona Restaurant Association, Arizona Retailers Association, Boeing, Arizona School Board Association, National Federation of Independent Business, Arizona Hospital Association, Lockheed Martin, Abbot Labs, and Raytheon.

implementation thereof has been stayed while additional amendments and revisions thereto are being considered.

C. TEP has worked with the Commission Staff and other interested parties towards finalization of the Electric Competition Rules and the implementation of Competitive Retail Access in Arizona.

D. The Parties acknowledge that in order to restructure the Arizona retail electric industry to provide for Competitive Retail Access and customer choice, this Settlement Agreement provides TEP's shareholders a reasonable opportunity to recover their prudently incurred investments and costs, including stranded costs.

E. The Parties also acknowledge that each Affected Utility (as defined in the Electric Competition Rules) has unique financial and other circumstances such that the Commission should review the provisions of this Settlement Agreement relating to TEP's recovery of stranded costs independently from the proposals of any other Affected Utility.

F. The Parties believe that this Settlement Agreement provides for the timely implementation of Competitive Retail Access in TEP's CC&N Service Territory and for TEP's shareholders to have a reasonable opportunity to recover their prudently incurred investments and costs. The Parties further believe that competition in the electric industry will benefit all customers in providing greater efficiencies and lower electric power costs. Accordingly, this Settlement Agreement is to be interpreted so as to bring about these consumer benefits as soon as possible.

G. The Parties further believe that the terms and conditions of this Settlement Agreement are just, reasonable and in the public interest in that they, among other things,

provide for Competitive Retail Access in TEP's Service Territory, establish rate reductions for all TEP customers, set a mechanism for stranded cost recovery and resolve contentious litigation.

H. The Parties desire that the Commission issue an Order: (a) finding that the terms and conditions of this Settlement Agreement are just and reasonable; (b) concluding that this Settlement Agreement is in the public interest; (c) approving this Settlement Agreement; and (d) implementing the terms and conditions set forth herein (the "Commission's Approval Order").

NOW, THEREFORE, in consideration of the mutual covenants and promises contained herein and for other good and valuable consideration, the Parties hereto agrees as follows:

1. COMPETITIVE RETAIL ACCESS.

1.1 Competitive Retail Access in TEP's CC&N Service Territory shall commence sixty (60) days after the issuance of the Commission's Approval Order ("Commencement Date"), and subject to: (a) the provisions of effective Electric Competition Rules; and (b) the terms and conditions herein.²

1.2 Upon the Commencement Date, TEP shall make available for Competitive Retail Access the amount of system peak load set forth in the currently proposed Electric Competition Rules, plus an additional fifty-four (54) megawatts of load which shall be made available to eligible non-residential customers. Unless subject to judicial or

² The Parties recognize that Y2K issues will be of critical importance during the fourth quarter of 1999. Therefore, the Parties respectfully request approval of this Settlement Agreement on or before August 1, 1999 so that Competitive Retail Access may commence in TEP's service territory on or before October 1, 1999.

regulatory restraint, all TEP customers will be eligible to receive Competitive Retail Access on January 1, 2001.

1.3 The Parties shall urge the Commission to approve the Electric Competition Rules, at least on an emergency basis, so that meaningful Competitive Retail Access can begin in TEP's service territory subject to the provisions of Section 1.1 herein.

1.4 Electric Service Agreements ("ESAs"), in effect as of the Commencement Date, shall remain in effect, unless TEP and the respective parties thereto agree to a modification or a termination thereof. In the event that an ESA, in effect as of the Commencement Date, terminates by its terms prior to January 1, 2001, then the ESA customer shall have the option of choosing: (a) Competitive Retail Access; or (b) an extension of the ESA up to January 1, 2001 at the then-current contract price (with any applicable seasonal adjustment and continuing escalation that would have applied had the ESA not terminated).

2. STRANDED COST RECOVERY.

2.1 TEP shall have a reasonable opportunity to recover its stranded costs, including its regulatory assets. TEP shall be authorized to recover its stranded costs in the following manner:

(a) The Commission shall authorize TEP to implement a competition transition charge ("CTC") in two components: (i) a "Fixed" CTC; and (ii) a "Floating" CTC.

(b) The Fixed CTC shall be set so as to equal a charge of 0.93 cents/kWh (average) ("Fixed CTC amount"), which shall include recovery of TEP's regulatory assets. The Fixed CTC component shall terminate when it has yielded a stranded cost

recovery of four hundred fifty million dollars (\$450 million), or on December 31, 2008, whichever occurs first. When the Fixed CTC terminates, unbundled service rates will be reduced by the same amount. The amortization schedule for the \$450 million of Fixed CTC is attached hereto as Exhibit A. The parties acknowledge that the actual collection of the Fixed CTC will vary with actual kWh sales.

(c) The Floating CTC shall be calculated using a Market Generation Credit ("MGC") methodology (as defined in subsection 2.1(d) below) and will terminate on December 31, 2008. The Floating CTC shall be determined on a quarterly basis. TEP shall set the Floating CTC amount forty-five (45) days prior to each calendar quarter. The Parties acknowledge that the Floating CTC amount may vary from month-to-month, as the MGC varies. The Floating CTC amount shall equal the difference between the customer's bundled rate and the sum of: (i) the MGC; (ii) the "Adder" (as defined in subsection 2.1(e) below); and (iii) the unbundled charges for: a) distribution; b) transmission; c) metering; d) billing; e) ancillary services; f) fixed must-run generation; g) system benefits; and h) the Fixed CTC. In a given quarter, the Floating CTC can have a negative value, in which case the negative value will be credited to the customers' monthly bill. The sum of the MGC and the Adder shall be reflected on customers' bills as a single line item.

(d) The monthly MGC amount shall be calculated in advance and stated as both an on-peak value and an off-peak value. The monthly on-peak MGC component shall be equal to the Market Price multiplied by one plus the appropriate line loss (including unaccounted for energy ("UFE")) amount. The Market Price shall be equal to the Palo Verde NYMEX futures price, except when adjusted for the variable cost of

TEP's must-run generation. The Market Price shall be determined 45 days prior to each calendar quarter using the average of the most recent three (3) business days of Palo Verde NYMEX settlement prices. The off-peak MGC component shall be determined in the same manner as the on-peak component, except that the Palo Verde futures price will be adjusted by the ratio of off-peak to on-peak hourly prices from the California Power Exchange of the same month from the preceding year. The market price shall reflect the cost of serving a one hundred percent (100%) load factor customer. If the nature of the Palo Verde NYMEX changes such that it no longer accurately reflects the intent of the Settlement, the Company, Staff or any other interested party may request that an alternative index be utilized to the extent such index is consistent with the Settlement.

(e) The Parties acknowledge that the purpose of the Adder is to estimate the cost of supplying power to a specific customer or customer group and stratum relative to the value of the NYMEX futures prices used in the calculation of the market price for a one hundred percent (100%) load factor. The Adder will be adjusted for each customer class and stratum, shall average 4.23-5 mills and shall be subject to the same line loss adjustment outlined in subsection (d) herein. However, the initial Adder for any customer shall not be less than 3.02-5 mills.

(f) The Parties acknowledge that the Adder is intended to estimate the difference between the flat load costs associated with the PV index and actual customer load characteristics plus an additional amount for costs that will not be readily quantifiable until the Arizona market more fully develops. After June 1, 2004, any interested party ~~Party to this Settlement Agreement~~ may submit a request to the Commission to alter/amend the initial Adder based upon actual market conditions. Any

such requests will be considered as part of the rate modifications contemplated pursuant to Section 5.2.

(g) The Commission shall authorize TEP to securitize any portion of the CTC, provided that TEP shall file with the Commission a financing application that provides that TEP will share the benefits of such securitization with its customers.

(h) The CTC for an ESA customer shall be calculated using the customer's ESA price as of May 1, 1999 (subject to any automatic escalation provisions contained in the ESA) as the customer's bundled rate.

(i) Self-generation and other reductions in purchases "off-the-grid" shall not be subject to the CTC (consistent with the Electric Competition Rules).

(j) During a month in which must-run generation is provided to meet retail load, the Market Price component used in calculating the on-peak MGC shall be a weighted average of the Palo Verde NYMEX futures price and the must-run variable cost charges that are levied on scheduling coordinators serving retail customers in the TEP load zone during that month, consistent with AISA protocols.

3. SEPARATION OF COMPETITIVE AND NON-COMPETITIVE SERVICES.

3.1 On or before December 31, 2002, TEP shall transfer its generation and other assets deemed to be competitive (as defined in the Electric Competition Rules) to a subsidiary of TEP, at market value. Commission approval of this Settlement Agreement shall constitute any necessary approval or waiver under Title 40, Arizona Revised Statutes and the Commission's Affiliated Interest Rules (A.A.C. R14-2-801, *et seq.*) for the formations of the subsidiary and the transfer of the assets. At such time that TEP

effectuates the transfer of its generation assets, it shall be required to procure generation for its standard offer customers in accordance with the Electric Competition Rules.

4. UNBUNDLED RATES.

4.1 TEP's rates shall be fully unbundled into separate charges for: (a) distribution; (b) transmission; (c) metering; (d) billing; (e) ancillary services; (f) fixed must-run generation; (g) system benefits; and (h) standard offer generation, the sum of which shall not exceed a customer's current bundled rates. For TEP's standard offer customers, the CTC shall be included in the cost of standard offer generation service, and shall be separately identified on the customers' bills.

4.2 TEP's cost for variable must-run generation shall be billed directly to scheduling coordinators in accordance with AISA protocols, and shall be included in the standard offer generation charge.

4.3 TEP shall take reasonable steps to minimize the "collapsing" of tariffs that are on file with the Commission as of the Commencement Date.

4.4 TEP shall charge rates for transmission and ancillary services based upon its FERC Open Access Transmission Tariff.

4.5 TEP's tariffs shall be unbundled for all customers, including those who are not initially eligible for Competitive Retail Access.

4.6 TEP shall defer for future recovery its cost to implement Competitive Retail Access. The Commission shall authorize TEP to recover its reasonable and prudently incurred Competitive Retail Access implementation costs as a plant cost and/or deferred debit subject to review in the TEP June 1, 2004 filing (as discussed in section 5.2 below.)

5. RATE REDUCTIONS.

5.1 TEP shall reduce the rates charged to all non-ESA customers by two percent (2%) as follows: one percent (1%) on July 1, 1999 and one percent (1%) on July 1, 2000. Except for the non-ESA two percent (2%) rate reductions, TEP's rates shall be frozen until December 31, 2008, except for: (a) those adjustments that will result as a consequence of this Settlement Agreement; (b) changes in TEP's transmission tariffs due to AISA or Desert STAR; and (c) changes authorized hereinbelow.

5.2 TEP shall file a report with the Director of the Utilities Division by June 1, 2004 identifying any required modifications to the Fixed or Floating CTC, TEP's distribution tariffs and other unbundled components ("TEP June 1, 2004 filing"), that would have the effect of reducing standard offer and/or overall unbundled rates while providing for TEP's recovery of costs associated with provider of last resort service in standard offer rates. This report shall include a recommendation as to whether the Fixed CTC can be eliminated/reduced prior to December 31, 2008. Any changes in TEP's rates made pursuant to this section 5.2 shall be implemented no later than January 1, 2005.

5.3 TEP's rate reductions provided for herein shall constitute full compliance with provisions of the Electric Competition Rules requiring that Affected Utilities implement rate reductions.

6. TARIFF FILINGS.

6.1 The Parties agree that the Unbundled Distribution Tariffs, attached hereto as Exhibit B, are just and reasonable. The Commission's Approval Order shall include such a finding and approve TEP's Unbundled Distribution Tariffs.

7. CODE OF CONDUCT.

7.1 All transactions between TEP (the regulated Utility Distribution Company) and its affiliates engaged in Competitive Retail Access shall be governed by a Code of Conduct. Within thirty (30) days of the filing of this Settlement Agreement, TEP shall file with the Commission an Interim Code of Conduct. TEP will voluntarily comply with this Interim Code of Conduct until the Commission approves a final Code of Conduct for TEP in accordance with the Electric Competition Rules. TEP shall confer with the Parties prior to filing its Interim Code of Conduct.

8. CERTIFICATE OF CONVENIENCE AND NECESSITY.

8.1 TEP agrees to the amendment and modification of its CC&N in order to permit Competitive Retail Access consistent with the terms of this Settlement Agreement. The Commission's Approval Order shall contain the necessary findings and conclusions and constitute the necessary Commission Order amending and modifying TEP's CC&Ns to permit competitive Retail Access consistent with the terms of this Settlement Agreement.

9. INDEPENDENT SCHEDULING ADMINISTRATOR/INDEPENDENT SYSTEM OPERATOR.

9.1 TEP shall fully support the development of the Arizona Independent Scheduling Administrator ("AISA") and Desert STAR. TEP shall modify its FERC Open Access Transmission Tariff ("OATT") to be fully compatible with the AISA/ISO Bylaws and Protocols Manual. The Parties reserve their rights with respect to any AISA protocols, including the right to challenge or seek modifications to, or waivers from, such protocols. TEP shall file changes to its existing OATT consistent with this Section

within ten (10) days of Commission approval of this Settlement Agreement pursuant to Section 13.3.

10. RESOLUTION OF LITIGATION.

10.1 Upon issuance by the Commission of the Commission's Approval Order that is no longer subject to judicial review, TEP shall move to dismiss with prejudice all pending litigation brought by TEP against the Commission and assist the Commission in any remaining litigation regarding implementation of the Electric Competition Rules.

11. LOW-INCOME PROGRAMS.

11.1 To ensure that low-income customers and programs are not negatively impacted by the introduction and transition to Competitive Retail Access, TEP's System Benefits Charge as set forth in the tariffs filed herewith, shall include charges to maintain its existing low-income programs (which include weatherization, Life Fund, bill assistance and rate discounts) in an amount of at least current levels through December 31, 2004 when all such programs will be reviewed as part of TEP's June 1, 2004 filing. Additionally, the Parties agree to recommend to the Commission that TEP's low income rate discount program (with the exception of the medical discount which shall remain the same) be amended as follows: (a) to replace the current percentage discounts with a flat eight dollar (\$8.00) per month discount; (b) the applicant for the program must receive the bill in their name, be a residential customer and meet one-hundred fifty percent (150%) of the federal poverty income guidelines; and (c) the program would operate as follows: (i) the program would have an application which is self-declared/self-addressed and available in English and in Spanish; (ii) once TEP receives the application, it would be reviewed; (iii) once the customer has been

determined to be eligible, the discount would become effective immediately; (iv) participants who move within TEP's service territory would have their eligibility transferred with them; and (v) the customers would be notified annually by TEP when it is time to reapply.

12. WAIVERS.

12.1 The Parties agree that certain waivers for TEP of the Affiliated Interest Rules, Integrated Resource Planning Rules, certain conditions in Decision No. 60480, and certain Commission decisions are in the public's interest. The Commission's Approval Order shall include and grant to TEP waivers from the following as set forth below:

(a) A.A.C. R14-2-701, *et seq.* - Integrated Resource Planning Rules. TEP shall comply with the Integrated Resource Planning ("IRP") Rules until divestiture of its generation. After such time as divestiture occurs, the IRP Rules shall not apply to TEP pursuant to R14-2-702.A. Pursuant to R14-2-702.B, the Commission may apply the IRP Rules to TEP upon two years notice.

(b) ~~(b)~~ A.A.C. R14-2-801 *et seq.* - Affiliated Interest Rules (to the extent necessary to comply with this Settlement Agreement and the Electric Competition Rules). Additional Specific Waivers:

- R14-2-803 is limited to organizations or reorganizations of UniSource when the organization or reorganization changes the position of TEP (the UDC) in the holding company organizational structure.

- R14-2-804.A, the agreement by affiliates to allow Commission access to their books and records, is limited to investigations which are performed during the course of a rate case.
- R14-2-805.A is limited to require annual filings by only TEP (the UDC), unless the diversification plans or efforts of affiliates are likely to adversely affect the UDC's financial integrity.
- R14-2-805.A.2 is limited to a broad description of the nature of the business of each affiliate.
- R14-2-805.A.6. is limited to disclosure of allocations applicable to the UDC. The Commission's jurisdiction to require disclosure of the bases of other allocations should be reserved for rate cases.
- R14-2-805.A.9,10 and 11 is limited to production of such documents in rate cases and no annual filings are necessary.

(c) ~~(e)~~ Decision No. 60480, Holding Company Order:

- ~~Condition Nos. 2, 12, 13, 17, 19, 20, 21, 23, 25, 26, 27 and 28. 2, 13, 17, 23 and 25 are waived.~~
- Condition No. 12 is waived for sister companies. However, TEP will continue to file quarterly. UniSource will file annually. SEC filings will continue to be filed with the Commission.
- Condition No. 19 is modified to reduce the percentage of UniSource equity issuances that must be shared with TEP from 60 percent to 30 percent.

- Condition Nos. 19, 20 and 21 will remain in force, as modified, until the equity portion of TEP's capital structure reaches or exceeds 37.5 percent. TEP may request reconsideration of these waiver requests in conjunction with its next rate case.
- Condition No. 26 will remain in effect but is limited to TEP employees.
- Condition No. 27 is waived for the annual filing requirement. This waiver does not preclude the Commission from requiring the filing of information that would have been filed annually for purposes the Commission deems necessary, including but not limited to rate setting.

(d) Decision No. 59594 - Mid-Year DSM and Renewables Report: -TEP will comply with this filing requirement until such time as divestiture occurs. Thereafter, the requirement is waived.

(e) Decision No. 57586 - Director Transaction Report: This requirement is waived.

(f) Decision No. 58316 - Investment Subsidiary Liquidation Report and Purchase Agreement Summary: This requirement is waived.

(g) Decision No. 58497 - Avoided Cost Report -TEP will comply with this filing requirement until such time as divestiture occurs. Thereafter, the requirement is waived.

(h) Decision No. 57090 - Time of Use Letters —TEP will comply with this filing requirement until such time as divestiture occurs. Thereafter, the requirement is waived.

(i) Decision No. 56659 - Time of Use Report —TEP will comply with this filing requirement until such time as divestiture occurs. Thereafter, the requirement is waived.

(j) Decision No. 56526 - Fuel & Performance Filing (upon transfer of generation assets) — TEP will comply with this filing requirement until such time as divestiture occurs. Thereafter, the requirement is waived.

(k) Decision No. 57924 - Interruptible Report Filing (upon transfer of generation assets) — TEP will comply with this filing requirement until such time as divestiture occurs. Thereafter, the requirement is waived.

(l) Statistical Data on Generating Units Filing (upon transfer of generation assets) — TEP will comply with this filing requirement until such time as divestiture occurs. Thereafter, the requirement is waived.

(m) ~~(m)~~ — Generating Unit Outage Report Filing (upon transfer of generation assets) — TEP will comply with this filing requirement until such time as divestiture occurs. Thereafter, the requirement is waived.

(n) Cost Containment Report (Decision No. 59594) — This requirement is waived.

13. CONTINGENCIES TO THIS SETTLEMENT AGREEMENT.

13.1 Neither the Parties nor the Commission shall take any action that would diminish the recovery of TEP's stranded costs or regulatory assets provided for herein.

In entering into this Settlement Agreement, TEP has relied upon the Commission's irrevocable promise to permit recovery of TEP's stranded costs and regulatory assets as provided herein. Such irrevocable promise by the Commission shall be evidenced by the issuance of the Commission's Approval Order, shall survive the expiration of the Settlement Agreement and shall be specifically enforceable against this and any future Commission.

13.2 The Parties acknowledge that TEP's ability to offer Competitive Retail Access is contingent upon conditions and circumstances, a number of which are not within the direct control of the Parties. Accordingly, the Parties agree that it may become necessary to modify the terms of retail access to account for such factors, and they further agree to address such matters in good faith and to cooperate in an effort to propose joint resolutions for any such matters.

13.3 This Settlement Agreement shall not become effective until the issuance of a final Commission Order approving this Settlement Agreement, without modification, on or before August 1, 1999. In the event that the Commission fails to approve this Settlement Agreement without modification according to its terms on or before August 1, 1999, any Party to this Settlement Agreement may withdraw from this Settlement Agreement and shall thereafter not be bound by its provisions; provided, however, that if TEP withdraws from this Settlement Agreement, the Settlement Agreement shall be null and void and of no further force and effect. Parties so withdrawing shall be free to pursue their respective positions without prejudice. Approval of this Settlement Agreement by the Commission shall make the Commission a Party to this Settlement Agreement and fully bound by its provisions.

13.4 TEP shall not be prevented from seeking a change in unbundled or Standard Offer rates prior to December 31, 2008, in the event of (a) conditions or circumstances which constitute an emergency, such as the inability to finance on reasonable terms; or (b) material changes in TEP's cost of service for Commission regulated services resulting from federal, tribal, state or local laws, regulatory requirements, judicial decisions, actions or orders. Except for the changes otherwise specifically contemplated by this Agreement, unbundled and Standard Offer rates shall remain unchanged until at least December 31, 2008.

13.5 Each provision of this Settlement Agreement is in consideration and support of all the other provisions, and expressly conditioned upon acceptance by the Commission without change. In the event that the Commission fails to adopt this Settlement Agreement according to its terms, this Settlement Agreement shall be deemed withdrawn and the parties shall be free to pursue their respective positions in these proceedings without prejudice.

13.6 This Settlement Agreement shall not preclude TEP from requesting, or the Commission from approving, changes to specific rate schedules or terms and conditions of service, or the approval of new rates or terms and conditions of service, that do not significantly affect the overall earnings of the Company or materially modify the tariffs or increase the rates approved in this Settlement Agreement. Nothing contained in this Settlement Agreement shall preclude TEP from filing changes to its tariffs or terms and conditions of service which are not inconsistent with its obligation under this Settlement Agreement.

14. MISCELLANEOUS PROVISIONS.

14.1 This Settlement Agreement represents an attempt to compromise and settle disputed claims in a manner consistent with the public interest. Nothing contained in this Settlement Agreement is an admission by any of the Parties that any of the positions taken, or that might be taken by each in a formal proceeding, is unreasonable. In addition, acceptance of this Settlement Agreement by the Parties is without prejudice to any position taken by any party in these proceedings.

14.2 The Parties agree that they shall make all reasonable and good faith efforts necessary to (a) obtain final approval of this Settlement Agreement by the Commission; and (b) ensure full implementation and enforcement of all the terms and conditions set forth in this Settlement Agreement. Neither the Parties nor the Commission shall take or propose any action which would be inconsistent with the provisions of this Settlement Agreement. All parties shall actively defend this Settlement Agreement in the event of any challenge to its validity or implementation.

14.3 To the extent that any provision of this Settlement Agreement is inconsistent with any existing or future Commission order, rule or regulation or is inconsistent with the Electric Competition Rules as now existing or as may be amended in the future, the provisions of this Settlement Agreement shall control and the approval of this Settlement Agreement by the Commission shall be deemed to constitute a Commission-approved variation or exemption to any conflicting provision of the Electric Competition Rules.

14.4 The provisions of this Settlement Agreement shall be implemented and enforceable notwithstanding the pendency of a legal challenge to the Commission's approval of this Settlement Agreement, unless such implementation and enforcement is stayed or enjoined by a court having jurisdiction over this matter. If any portion of the

Commission's Approval Order or any provision of this Settlement Agreement is declared by a court to be invalid or unlawful in any respect, then (a) TEP shall have no further obligations or liabilities under this Settlement Agreement, including, but not limited to, any obligation to implement any future rate reductions under Section 5.1 not then in effect; and (b) the modifications to TEP's CC&Ns referred to in Section 8.1 shall be automatically revoked, in which event TEP shall use its best efforts to continue to provide noncompetitive services (as defined in the proposed Electric Competition Rules) at then current rates with respect to customer contracts in effect for competitive generation (for the remainder of their term) to the extent not prohibited by law and subject to applicable regulatory requirements.

14.5 The terms and provisions of this Settlement Agreement apply solely to and are binding only in the context of the purposes and results of this Settlement Agreement and none of the positions taken herein by any party may be referred to, cited or relied upon by any other Party in any fashion as precedent or otherwise in any other proceeding before this Commission or any other regulatory agency or before any court of law for any purpose except in furtherance of the purposes and results of this Settlement Agreement.

14.6 The filing of this Settlement Agreement with the Commission shall constitute TEP's compliance with the requirements of Decision No. 61677 that it file with the Commission a plan for stranded cost recovery and unbundled tariffs on or before June 14, 1999.

14.7 The Parties agree and recommend that the Commission schedule public meetings and hearings for consideration of this Settlement Agreement. The filing of this Settlement Agreement with the Commission shall be deemed to be the filing of a formal

request for the expeditious issuance of a procedural schedule that establishes such formal hearings and public meetings as may be necessary for the Commission to approve the Settlement Agreement and that afford interested parties adequate opportunity to comment and be heard on the terms of this Settlement Agreement consistent with applicable legal requirements.

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15. Proposed Order.

15.1 Within thirty (30) days of the filing of this Settlement Agreement, TEP shall file with the Commission a Proposed Form of Order approving this Settlement Agreement. TEP shall confer with the Parties prior to filing the Proposed Form of Order.

DATED as of this _____ day of June, 1999.

TUCSON ELECTRIC POWER COMPANY

By: _____

Title: _____